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In The

Supreme Court of the United States

October Term, 1995

Hughes & Luce, L.L.P.,
Alan J. Bogdanow,
Tax Matters Partner,

Petitioner

v.

Commissioner of Internal Revenue,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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REPLY TO BRIEF IN OPPOSITION

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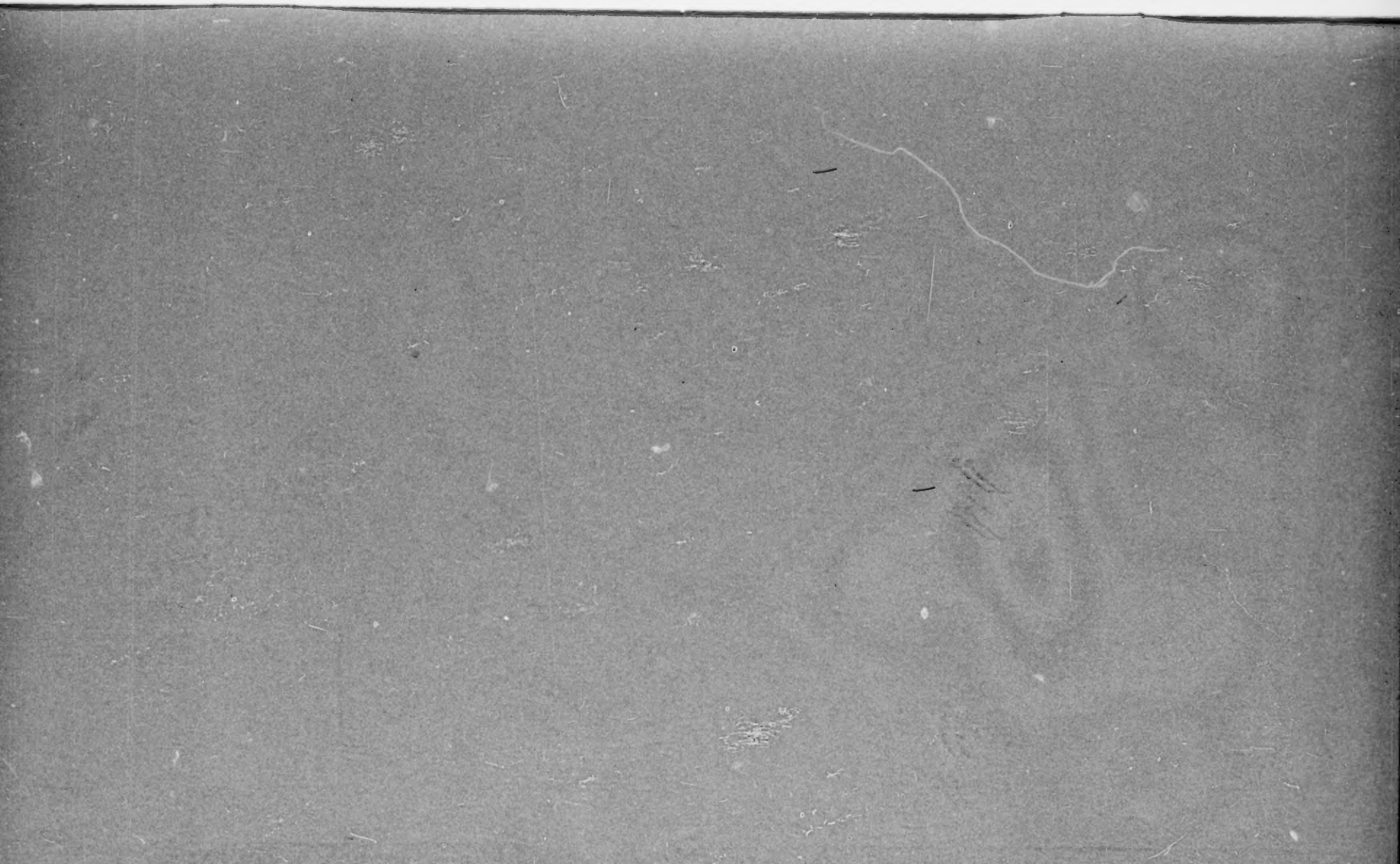

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REPLY TO BRIEF IN OPPOSITION

RESPONSES TO OPPOSITION

1. THE COMMISSIONER ERRONEOUSLY ALLEGES THAT THERE IS NO SPLIT OF AUTHORITY ON THE ERRONEOUS DEDUCTION EXCEPTION TO THE TAX BENEFIT RULE.

A. Northwestern States Portland Cement Co. v. Huston is a tax benefit rule case.

The Commissioner argues at page 6 of her Brief in Opposition that the 1942 decision of the United States Court of Appeals for the Eighth Circuit (the "Eighth Circuit") in Northwestern States Portland Cement Co. v. Huston, 126 F.2d 196 (8th Cir. 1942), was not a tax benefit rule case, essentially because the words "tax benefit rule" were not used therein, and that the Eighth Circuit did not adopt the "erroneous deduction exception" therein. These arguments are specious, at best. A simple review of the facts and legal arguments presented in Northwestern States demonstrates a classic pattern of the tax benefit rule. The fact that the case was decided in 1942, before the phrases "tax benefit rule" and "erroneous deduction exception" were in vogue does not alter the holding or the importance of this Eighth Circuit decision.

In Northwestern States, taxpayer transferred $100,000 from its surplus to its reserve accounts and erroneously treated this transfer as giving rise to a depreciation deduction. 126 F.2d at 198. The deduction of $100,000 was allowed to stand after audit as charges

to operations. Fifteen years later (in 1932), taxpayer decreased its reserves by $75,000, transferring this amount to its surplus account.

The Commissioner argued, among other things, that the return of the previously deducted dollars to surplus should give rise to income in 1932, since the creation of the reserve had decreased taxpayer's tax liability in the earlier, closed taxable year. 126 F.2d at 199. This was a classic tax benefit rule argument.

The Eighth Circuit disagreed with the Commissioner, finding that "the additions to reserves in the years 1916 and 1917, being legally nondeductible, represented taxable income in those years, and that the restoration to surplus made in 1932 was not taxable income." 126 F.2d at 200. The Commissioner's remedy was to restore the additions to income in the year the deductions were originally taken. Id. (citing Peabody Coal Co. v. Commissioner, 18 B.T.A. 1081 (1930), aff'd, 55 F.2d 7 (7th Cir. 1931); G. M. Standifer Construction Corp. v. Commissioner, 30 B.T.A. 184, 187 (1934); Creamette Co. v. Commissioner, 37 B.T.A. 216, 221

(1938)). **This is the same reasoning used by the Tax Court in adhering to the "erroneous deduction exception" to the tax benefit rule.** See Hughes & Luce v. Commissioner, 68 T.C.M. (CCH) 1169 (1994), rev'd on this issue, 70 F.3d 16 (5th Cir. 1995); Canelo v. Commissioner, 53 T.C. 217, aff'd on other grounds, 447 F.2d 484 (9th Cir. 1971); Gmelin v. Commissioner, 55 T.C.M. (CCH) 1411 (1988), aff'd without op., 891 F.2d 280 (3rd Cir. 1989).

The Eighth Circuit distinguished the treatment of erroneously deducted reserves from that of reserves for which deductions are lawfully taken. In the latter circumstance, the restoration of a lawfully deducted reserve creates income in the year of restoration. 126 F.2d 200 (quoting Creamette Co. v. Commissioner, 37 B.T.A. at 221). Hence, the "tax benefit rule" applied only when the original deduction was properly taken. The Eighth Circuit would not allow the Commissioner to convert what was not taxable income in 1932 into taxable income for that year to correct the barred deficiencies from the earlier taxable year. 126 F.2d at 201.

Again, this is the same reasoning used by the Tax Court and rejected by the United States Court of Appeals for the Fifth Circuit in this case. Hughes & Luce v. Commissioner, 68 T.C.M. (CCH) 1169 (1994), rev'd on this issue, 70 F.3d 16 (5th Cir. 1995).

B. Northwestern States Portland Cement Co. v. Huston is still the law of the Eighth Circuit.

The Commissioner argues at page 7 of her Brief in Opposition that Northwestern States Portland Cement is no longer the law of the Eighth Circuit. This argument is based on a strained reading of four cases, none of which implicate the erroneous deduction exception to the tax benefit rule.

The Commissioner cites James M. Pierce Corp. v. Commissioner, 326 F.2d 67, 70 (8th Cir. 1964), as creating doubt that the "reasoning" of Northwestern States survives today. The problem is that James M. Pierce Corp. involved the treatment of properly reserved prepaid subscriptions as income upon restoration. This is consistent with Northwestern States, which, as mentioned above, distinguished between the restoration of properly deducted and improperly deducted reserves.

Neither do any of the other three cases cited by the Commissioner implicate the "erroneous deduction exception" to the tax benefit rule. See Austin v. Loftsgaarden, 768 F.2d 949, 955-56 (8th Cir. 1985)(en banc) (tax benefit rule mentioned, but not applicable to case involving rescissionary damages award), rev'd on other grounds sub. nom., Randall v. Loftsgaarden, 478 U.S. 647 (1986); Crystal Lake Cemetery Ass'n v. United States, 413 F.2d 617, 622 (8th Cir. 1969)(deposits to a maintenance trust were not taxable income until such funds were taken from the trust under a claim of right); Reynolds v. Boos, 188 F.2d 322, 325-326 (8th Cir. 1951) (refused to apply the tax benefit rule when previously deducted rent was forgiven as a gift). None of these cases presented facts in which the "erroneous deduction exception" would have been implicated.

2. THE DUTY OF CONSISTENCY DOES NOT APPLY IN THIS CASE.

The Commissioner alleges in footnote 3 at page 8 of her Brief in Opposition that taxpayer's Petition should be denied because taxpayer's case fails in any event under the duty of consistency.

This issue is not before this Court, since the United States Court of Appeals for the Fifth Circuit did not reach the issue in its opinion below. Nonetheless, taxpayer wants this Court to be aware that application of the duty of consistency in this context is unprecedented,[1] and its possible application does not -- as the

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[1] First, the change in treatment of the Service Costs was instituted not by the taxpayer, but by the Internal Revenue Service. Taxpayer did not voluntarily change its method of reporting such costs. Indeed, taxpayer offered, and remains willing, to continue to treat its Service Costs as it has historically treated them to prevent any "windfall."

Second, and perhaps most importantly, the duty of consistency does not apply to the legal treatment of reported items. Taxpayer has not changed one factual representation upon which its prior reporting of Service Costs was based. Taxpayer reported, and continues to show, "rebillable costs" and "reimbursements" on its information returns. Taxpayer has not misrepresented or in any way hidden these items. The only change in this case has been the legal treatment of the reported items -- that the Service Costs are not deductible when paid and that reimbursements thereof do not constitute income. Accordingly, the duty

Commissioner seems to suggest -- give this Court independent grounds upon which to deny taxpayer's Petition.

Respectfully submitted,

May 14, 1996

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of consistency does not apply, and does not give this Court independent grounds upon which to deny taxpayer's Petition.